Comments on the Present Business Recession
by
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I

The purpose of this memorandum is to set forth in broad outline the kind of program which seems best adapted for dealing with the current economic recession. We begin with a reference to what has happened because it is difficult otherwise to get a fair perspective of the problem.

The great depression reached a double bottom in the middle of 1932 and February-March 1933. Until the fall of 1934, the recovery was very erratic. From then until September 1936 there was a strong and wholesome upward movement, as is perhaps best indicated by the fact that production and employment rose comparatively much and commodity prices comparatively little. From September 1936 to March 1937, there was evidence that the recovery had entered upon an unwholesome phase, for this period was marked by a rapid rise of prices both here and abroad. There were evidences of an incipient boom, such as wage-price spirals, forward buying, inventory accumulation, and the like. Labor disputes undoubtedly intensified these conditions.

The period just described marked the peak of the recovery. The Board's index reached 121 in December and 118 in March. Since March the stock market has receded, while business remained on a plateau until August. Since August there has been a succession of violent breaks in the stock market comparable in range, if not in volume, with the breaks in 1929. The decline from last March to the lowest point yet reached has been 40 to 50 per cent. The decline since August has been accompanied by some recession in business, the Board's index of production falling from 118 in August to 111 in September and to an estimated 108 in October. There is no current evidence that the recession has come to an end.

Whereas two or three months ago, we were considering the possibility of a business recession this fall, we are now faced with the definite fact that it is under way. That some recession might be necessary and desirable for assurance of continuance of the recovery movement following the excesses of last winter and spring was foreseen at that time, but probably no one foresaw that it would be accompanied by so great and violent a decline in securities. As matters now stand, probably no one can say with entire confidence whether we are facing a minor or a major depression.

It is helpful, as bearing upon this question and also upon the question of what sort of recovery program is now needed, to compare our present situation with that following the downturn in 1929. There are important differences between the two periods which, if taken by themselves, would point to nothing more serious than a minor depression. These differences relate chiefly to 1) durable goods 2) speculation 3) banking. As regards durable goods, there is a striking difference in favor of the present. Our needs for housing, public utility equipment, railroad equipment, and industrial plant equipment, are all undoubtedly greater than in 1929. As regards speculation, there is now nothing comparable to the great volume of speculative credit in the security markets and in real estate, and to these should be added the difference in our foreign investment position. In banking, a large number of our weaker banks have disappeared, we have now Federal deposit insurance, and there is, perhaps, a changed attitude in bank examination. On these major grounds there is a strong presumption that we cannot now have a depression like the last.

There are, however, some other differences between the two periods which, partly because they are wholly new in our experience, greatly confuse any attempt at a forecast. One is the monetary situation. We have gone through the longest recovery in our history with continuing extreme ease of money. Broadly speaking, therefore, a policy of monetary ease cannot be counted upon as a corrective for depression as it used to be, though this does not mean that there may not be room for effective monetary action as we proceed. Probably an even more important difference is the fact that we have had a public spending program of large proportions, which has been financed by Government borrowing. A third difference is the present relation between government and business. We have been having a combined recovery and reform program for which there is no precedent in business cycle history. We do not know how compatible they are under conditions of business recession, or what adjustments will or can be made. Perhaps this is the largest question of the three.

There appear to be two main lines of procedure for a government policy designed to hold the recession to a minimum and hasten a resumption of recovery. One is a renewal of the policy of large budgetary deficits. The other is to encourage private investment by endeavoring to remove specific obstacles, while adhering to the announced policy of budget balancing. In our judgment, in the present circumstances, the latter policy offers much the better prospect of sustained success.

The most recent budgetary estimates, when adjusted for transfers to trust accounts and similar items not representing actual out-payments to the community, indicate an approximate balance of revenue and expenditure for the fiscal year 1938. If the administration adheres to this budget, and gets the revenue there estimated, there will be a decrease in the net income creating expenditure of the Government in this fiscal year of some two and a half to three billion dollars. Allowing for the secondary effects upon community spending, it seems conservative to estimate that the national income will be reduced by ten per cent compared with what it would be if the budgetary deficit were continued upon the scale of the fiscal year 1937. We must thus face the fact that if this change occurs in a year when private business activity has lost its recovery momentum, a business recession of considerable magnitude might not be avoidable except upon one or the other of the twy hypotheses mentioned; either the unbalanced budget policy must be resumed or an alternative program designed to encourage businessspending sufficiently to fill the gap must be devised.

In our judgment, the time has come to effect the transition from public deficits to private investment. The transition might well have been smoother had it been started sooner. If now the price of transition must be some minor recession of business, it seems the better course to pay that price. A minor recession after the longest period of recovery in our history, and particularly after the excesses of last winter, is not by itself to be regarded as a major economic calamity; and it should, if wisely handled, lay the ground work for a resumption of recovery upon a more normal, self-sustaining basis.

There appear to be serious objections, under present circumstances to a recovery policy based upon a renewal of the budgetary deficits. It would involve an abrupt change of the administration's recently announced and reiterated policy, which would shake confidence much more now than if the announcements had not been made. It would come at a time when the banks, after a long period of government security buying, have for more than a year been showing increasing resistance and have reduced their holdings substantially. The complaint is even now being made that sales of government securities by banks to private investors have been absorbing investment funds which would otherwise be available for private capital issues, and that this, in part at least, is what is wrong with the new issues market. As yet, this criticism is probably exaggerated, but if government borrowing were resumed on a substantial scale there would in all probability develop a difficulty of this kind.

A further difficulty would arise in interest rates. The policy during the recovery was progressively to lower interest rates in order to encourage first refunding and then new capital issues and mortgage financing. But there appear to be limits of time and magnitude upon this process. We have found that after a prolonged rise of government security prices, and when bank holdings of governments had become large, the banks developed a desire to sell governments, though under no real reserve pressure to do so, in order to protect profits or avoid losses. For this reason, probably, many banks have appeared more inclined to adjust positions through their long-term assets than through the short-term money market. Under these conditions, the structure of interest rates becomes increasingly unstable. Results which might have been achieved when bank holdings of government securities were smaller, and when these securities had had a lesser rise in price, become increasingly difficult to achieve or maintain. Any serious set-back in the government market, the possibility of which would become progressively greater as new issues were offered, then tends to dry up both refunding and new capital issues. There have been indications this year that we are approaching that kind of impasse.

II

We have dwelt at some length upon the problems of deficit financing because we regard it as essential to recognize that the policy of budget balancing in this year of business uncertainty does create a definite and substantial reduction in the national income which calls for a positive recovery program, but that this program ought not, under present circumstances, to take the form of a prolongation of the budgetary deficits.

There is, of course, the possible view that because of large latent demand for housing, utility, railroad, and plant equipment, comparative absence of speculative excesses, and better banking conditions than in the last depression, business recession will find comparatively little to feed upon and, after a short period, business will turn up again, as has happened many times before. We cannot, however, afford to rely entirely on this course of events. Virtually all such earlier experiences were accompanied by a change of monetary conditions, whereas this time money is easy and has been for a long time. Furthermore, former experiences have not included the important new factors now presented by the budgetary problem and by the failure of government and business to find a common ground on which to attack the problem. The fact that adverse factors present in the past are not now present offers the real basis for hope that a constructive program of specific adjustments could now succeed; it would not justify, however, a failure to try to set up such a program.

During the recent recovery the main emphasis was upon increasing consumer income in the expectation that the consumer demand thus created would lead to increased investment in plant and equipment for the production and distribution of goods to meet that demand. At the present juncture, it seems probable that we could make better headway by a reversal of this emphasis, and it is of fundamental importance to recognize that the policy of budget balancing can be based only upon this assumption.

The kind of program here suggested should include, we think, some kind of general statement, possibly in the form of a message by the President to Congress, giving indication of awareness of the current economic situation, clarifying objectives, and encouraging a spirit of cooperative attack upon the forces making for depression. It seems to us that this could be done entirely consistently with all major reform objectives, and that it is essential to the attainment of the major objective of a better standard of living for the whole population, which can only be achieved by a fuller use of the nation's factors of production.

The problem in its strictly economic aspects suggests primarily a program of study, and where feasible, of definite measures designed to remove specific obstacles to private investment. The following outline broadly indicates the objectives we have in mind.

1. Removal of obstacles to investment in four main fields

    a) Utilities
    b) Housing
    c) Railroads
    d) General plant and equipment

2. Removal of possible defects in tax system

    a) Undistributed profits tax
    b) Capital gains tax
    c) Social security taxes?

3. Removal of possible defects in financial machinery

    a) Stock market
    b) New capital issues market
    c) Building finance

The enumeration of items does not indicate necessarily that we think some action should or could be taken with respect to each item. Still less does it mean that we feel competent to indicate, in every case, what specific actions might best be taken. But we do feel that definite possibilities of helpful action lie within the area indicated.

The basic consideration, as has been earlier stated, is that in the main fields of investment, the possibilities and the need for expansion appear sufficiently real to give promise of substantial response. In the case of residential housing alone, which since the war has shown a range of from $5 billion in 1925 to $250 million in 1933, and in which the annual expenditure has now ruled far below the statistical average for eight years, there is room for expansion of sufficient magnitude to replace the gap resulting from removal of the budgetary deficit. Past experience seems to indicate that such a rapid run-up of costs as occurred in the first half of this year does not prove very rigid in the face of falling demand. Whether by subsidy, further improvements in finance, guaranteed annual wages for building labor, or by other devices, a substantial housing movement could be generated are questions requiring careful technical study, but over a period this appears to be the most promising field for recovery measures.

A more immediate point of attack upon the continuance of recession is the utilities. Here the need for equipment, though less in magnitude than in the case of housing, is more clearly defined and more pressing, and could probably be more promptly released. Whatever is to be the final outcome of present differences between the administration and the utilities, some means should be found, possibly through resumption of the President's Power Conference, to solve the existing state of fear and uncertainty, and to enable this industry to play its full part in reviving industrial activity.

As regards the railroads, it may be that no substantial equipment buying will occur until a sufficient increase of traffic is broughtabout through expansion of other industries, but there are in addition the problems of burdensome debt structure and advancing wage costs, the question how far the latter can be compensated for through rate adjustment, or what other measures of adjustment may be feasible.

As to industrial plant and equipment, it has been estimated by Mr. Terborgh of the Board's staff that investment in this field in the current year is over three billion dollars, or roughly equal to 1928; but in considering the outlook for future years, allowance must be made for the long duration of the depression, the increase of population, and the development of new technique. The rise of wages is in itself a powerful stimulus to technological advance, if the latter is given reasonable encouragement.

There is now wide-spread complaint that our tax system, especially the undistributed profits tax in its present form, threatens seriously both to weaken initiative and to impair corporate savings, which in the past has been a major source of new investment. There is also complaint that the capital gains tax, in its present form, accentuates the instability of the stock market. A thorough review of these taxes - and I understand the Treasury is making such a review - would be a constructive step, not only for its direct results in tax revision, but also because of its favorable effect upon business sentiment.

The financial items of the program, though deserving further careful study, are probably secondary to those already discussed in their possibilities of providing immediately effective encouragement to revival. The thinness of the stock market, its great disorderliness, and the great extent of the decline, exceeding that of any previous year except 1929, may well mean that the regulations need some further modification. The same may be true of the capital issues market, though the decline of the stock market and the uncertainty as to the future of business conditions would appear to be the major explanation of the drying up of new issues. Undoubtedly the best way to strengthen the capital markets would be through the development of some such program for encouraging investment as is here suggested.

As regards monetary policy, there is perhaps no occasion for detailed comment at this time, beyond the suggestion that at the next meeting of the Open Market Committee it would seem desirable to survey the major policies in the light of the current economic situation.